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# In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 1037

LIKINS-FOSTER HONOLULU CORP., et al.,
*Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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# In the Supreme Court of the United States

OCTOBER TERM, 1969

**No.** .....

LIKINS-FOSTER HONOLULU CORP., et al.,
*Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

Likins-Foster Honolulu Corp.; Aliamanu Homes Limited; Likins-Foster Olathe Corp.; Likins-Foster Topeka Corp.; Likins-Foster Salina Corp.; Cochiti Pumice Company, Lomita Homes, Inc.; Cardiff Homes, Inc.; Highland Park Homes, Inc.; Biggs Rental Co.; Foster Homes, Ltd.; Foster Development Corp.; Central Development Co., Ltd.; Likins-Foster Ord Corp., a liquidated corporation; Likins-Foster Monterey Corp., a liquidated corporation; Likins-Foster Biggs Corp., a liquidated corporation; and Likins-Foster El Paso Corp., a liquidated corporation, respectfully

pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Tenth Circuit entered in this proceeding on November 16, 1969.

## OPINIONS BELOW

The opinion of the Court of Appeals has not yet been officially reported. It is unofficially reported at 69-2 U.S.T.C. ¶ 9672 and is reproduced in Appendix A hereto. The opinions of the Tax Court of the United States are reported at 25 T.C.M. 1390 (1966) and 26 T.C.M. 1021 (1967). The Tax Court opinions are reproduced in Appendices B and C hereto.

## JURISDICTION

The judgment of the Court of Appeals (App. A, p. 14)[1] was entered on November 16, 1969. The jurisdiction of this court is invoked under 28 U.S.C. 1254(1).

## QUESTIONS PRESENTED

1. Whether the date of the "sale or exchange" for purposes of section 337 of the Internal Revenue Code of 1954, a remedial measure designed to avoid double taxation on sales or exchanges in corporate liquidations, is the date title and possession pass, or is the date gain would be realized on the sale or exchange under ordinary circumstances. The setting in which the question arises is a condemnation of property, where the court below applied a different rule than that applied in other types of involuntary conversions and in consensual sales.

2. Whether an accrual basis taxpayer realizes gain from a sale pursuant to a condemnation, prior to the date the litigation over the amount of the condemnation award is terminated.

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1. "App." refers to the appendix to this petition. "R." references are to printed record in this case, the appendix in the Court of Appeals.

3. Whether Internal Revenue Code section 482 authorizes allocating the entire profit from one member of a consolidated return group to another, in a manner contrary to the consolidated return regulations, where the trial court has found that tax avoidance would otherwise occur but the provisions of sections 269 and 1551, dealing with transfers to avoid tax, do not apply.

## STATUTORY PROVISIONS INVOLVED

Internal Revenue Code of 1954:

Sec. 269. Acquisitions made to evade or avoid income tax. (26 U.S.C. 269.)

Sec. 337. Gain or loss on sales or exchanges in connection with certain liquidations. (26 U.S.C. 337.)

Sec. 482. Allocation of income and deductions among taxpayers. (26 U.S.C. 482.)

Sec. 1501. Privilege to file consolidated returns. (26 U.S.C. 1501.)

Sec. 1502. Regulations. (26 U.S.C. 1502.)

Sec. 1503. Computation and payment of tax. (26 U.S.C. 1503.)

Sec. 1504. Definitions. (26 U.S.C. 1504.)

The above sections are reproduced in Appendix D hereto.

## STATEMENT OF THE CASE

Likins-Foster Honolulu Corp. (hereinafter referred to as Honolulu Corp.) owned all the stock of Topeka Corp.[2] and, until February 10, 1958, of the four Wherry corporations,[3] and filed consolidated returns including them. After

2. Likins-Foster Topeka Corp.

3. Likins-Foster Ord Corp.; Likins-Foster Monterey Corp.; Likins-Foster Biggs Corp.; Likins-Foster El Paso Corp. The separate incorporation of the four was for business reasons appearing in the Tax Court's findings. (App. B, p. 28.)

the consolidation was broken, the Wherry corporations filed separate returns until they were dissolved. (App. B, pp. 26-27.) The returns were on the accrual basis.

a. Topeka Corp. owned 421 rental houses and duplexes in Topeka, Kansas, which it sold on July 1, 1956 to the four Wherry corporations for a profit of $882,967.39. (App. B, pp. 28-29.) This followed a policy decision to dispose of these properties to the public, because of recent business developments. The Wherry corporations continued the rental business with the same staff for a year, but added persons to handle the sales. (App. B, pp. 29-30.) The 421 buildings were sold at retail in individual sales in June, 1957 (App. 30), for prices totaling $387,654 more than the Wherry corporations had paid for them (App. B, p. 30).

The gains from these sales were reported in the consolidated return as gains by the Wherry corporations, because the Topeka sale to them was treated as an intercompany transaction under the consolidated return regulations. (App. B, pp. 30-31.) It was offset against the Wherry corporations net operating loss carryovers, some of which antedated the first year they were included in the consolidated return. (App. B, pp. 31-32.) The Commissioner allocated the entire gain to Topeka, assigning Sec. 482 as his authority (App. B, p. 33), and the Tax Court, finding that the sale by Topeka to the Wherry corporations was made to avoid taxes (App. B, p. 64), sustained his action, as did the court below.

b. Each Wherry corporation owned a land lease on which it constructed housing for rent to military personnel, at two different air or military bases. (App. B, p. 46.) The loans made to finance the projects were guaranteed by the United States. (App. B, p. 28.) In 1957, the United States filed complaints in the appropriate district courts to condemn these properties. In the Texas district it deposited $2.00 as estimated just compensation, but increased the de-

posit by $337,998.00 on June 6, 1958. In the California district it deposited $782,053.00. (App. B, pp. 46-47.) The defendant corporations answered, putting the amount of just compensation in issue. (App. B, p. 47.) Trials of that issue occurred, and on January 21, 1960 a jury verdict was brought in in the California district, increasing the just compensation to $1,106,000. Judgment in accordance therewith was entered on June 23, 1960. (App. B, p. 51.) An appeal was taken and the judgment was affirmed on October 1, 1962. (App. B, p. 51.)

In the Texas district a jury verdict resulted in a judgment entered on August 7, 1962, which increased the just compensation to $1,700,000. That judgment was not appealed. (App. B, p. 51-52.)

In its complaints the United States asked for immediate possession, which it obtained. It then entered into so-called "three-party agreements" with the mortgage creditors under the debts it had guaranteed, undertaking to pay off the debts under their terms. (App. B, p. 48.) The Wherry corporations did not sign these agreements. (App. B, p. 49.)

Thereafter, on August 11, 1958, the four corporations adopted resolutions to dissolve, adopting plans of liquidadation. (App. B, p. 49.) Then, on August 19 and 20, 1958, they filed motions with the district courts to withdraw the funds deposited earlier by the United States, and orders permitting withdrawal were entered on August 20 and 25, 1968. The funds were actually withdrawn on August 27, 1958 and September 2, 1958. (App. B, p. 49.)

c. The income tax issues arising from these facts were, together with many other issues arising from other facts, taken to the Tax Court, which decided these issues adversely to the taxpayers. The Tax Court held that the "sale or exchange" in the condemnation occurred when title passed to the United States, which was on the filing of the

complaint, and that in consequence the corporations had adopted their plans of liquidation too late to enjoy the benefits of I.R.C. section 337, under which the gain would have been tax-free at the corporate level. (App. B, pp. 97-99.) On appeal, the Court of Appeals for the Tenth Circuit agreed with the Tax Court that section 337 did not apply for the reason given by the Tax Court. (App. A, p. 7.)

Both courts also held that gain from the sale arose when the United States assumed the mortgage indebtedness for which it had already been contingently liable as guarantor, notwithstanding that the amount of the just compensation remained contingent on the litigation not determined until years later. (App. A, p. 6; B, pp. 97-98.) The Court of Appeals disagreed with the Tax Court about the dates when this occurred, and with respect to one of the Wherry corporations remanded for additional findings and consideration on this point. (App. A, p. 6.) The effect of this disagreement is not to make section 337 applicable or otherwise to eliminate the tax to the corporations in some period, unless the remand proves to have this effect as to one of the four.

On the Topeka issue, the Tax Court held that the Commissioner correctly allocated the entire profit on the sales to Topeka, under section 482, notwithstanding the filing of consolidated returns. (App. B, p. 66.) It based this decision on its finding that the sale by Topeka to the Wherry corporations was dictated by motives of tax avoidance. (App. B, p. 64.) This aspect of the decision was affirmed by the Court of Appeals (App. A, pp. 10-12), which held that section 482 justified the allocation of the entire profit to one corporation in spite of the consolidated return regulations.

The Court of Appeals also affirmed other aspects of the Tax Court's decision which petitioners do not consider issues suitable for raising in a petition for certiorari.

## REASONS FOR GRANTING THE WRIT

1. Section 337 of the Internal Revenue Code of 1954 is remedial legislation designed to create a single tax, at the shareholder level only, when a corporation dissolves and incident thereto its assets are sold. The immediate purpose of the legislation is to establish a procedure to avoid the close fact determinations (cf. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950)) required by the only procedure available under prior law. This purpose is fully explained in S. Rept. No. 1622, 83rd Cong., 2d Sess., pp. 48-49, 258-259, and in H. Rept. No. 1337, 83rd Cong., 2d Sess., pp. 38-39, A106-A107. As the House report stated (p. A106):

> ". . . . under present law, the tax consequences arising from sales made in the course of liquidation depend primarily upon the formal manner in which transactions are arranged. The possibility that double taxation may occur in such cases results in causing the problem to be a trap for the unwary."

The manner in which this remedial legislation is to be applied to dissolutions triggered by involuntary conversions is an important question of federal law which has not been but should be settled by this Court. As the courts below both recognized (App. A, p. 7; App. B, pp.97-98), section 337 is applicable to dispositions pursuant to involuntary conversions as well as to those pursuant to consensual transactions. *Towanda Textiles, Inc. v. United States*, 180 F. Supp. 373 (Ct. Cl., 1960); *United States v. Morton*, 387 F. 2d 441 (C.A. 8, 1968); *Kent Manufacturing Corp. v. Commissioner*, 288 F.2d 812 (C.A. 4, 1961); and dictum in *Covered Wagon, Inc. v. Commissioner*, 369 F.2d 629, 634 (C.A. 8, 1966). There are no cases to the contrary, and respondent conceded the rule below. See Rev. Rul. 59-108, 1959-1 Cum. Bull. 72, which so holds.

The courts have had difficulty in evolving a principle to decide when the "sale or exchange" occurs[4] in an involuntary conversion,[5] and have been unable to produce a consistent pattern. Thus they have held that in a condemnation the "sale or exchange" occurs when the government files notice of taking, if title passes to the government thereon. *Wendell v. Commissioner*, 326 F.2d 600 (C.A. 2, 1964); *Covered Wagon, Inc. v. Commissioner*, 369 F.2d 629 (C.A. 8, 1967) (alternate ground only); and the instant case.

But they have held that the "sale or exchange" does not occur when property is destroyed by insured fire or explosion. *Kent Manufacturing Corp. v. Commissioner*, 288 F.2d 812 (C.A. 4, 1961); *United States v. Morton*, 387 F.2d 441 (C.A. 8, 1968). Since title to destroyed property is not transferred, the courts were not distracted by the question when title passed and went to the purposes and intended function of section 337 to determine its meaning and effect.

The legislative history of section 337 shows that it was intended to eliminate the technicalities and emphasis on formalities of the prior law. See S. Rept. No. 1622 at pp. 48-49 and H. Rept. No. 1337 at pp. 38-39, cited above. Yet under prior law the formality of passage of title was not controlling. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1954). Congress could not have intended to eliminate formalities and technicalities and yet restore the importance of the one technicality which prior law accorded no weight.

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4. For section 337 to apply, a corporation must adopt a plan of liquidation before the "sale or exchange by it of (its) property" if its gain or loss on the sale is not to be recognized. In addition, the liquidation must be completed within 12 months of its beginning.

5. Involuntary conversions are treated as sales or exchanges. Int. Rev. Code of 1954, §§ 1033, 1231(a).

According transfer of title such weight as is accorded it below means that two taxpayers situated precisely alike in their general relationship to the United States Government will have differing tax liabilities because, e.g., one owned property condemned under New York law, where title passes on filing, and the other owned property in Missouri, where title does not pass until the award of compensation is made. See *United States v. Morton,* supra, 387 F.2d 441, where that analysis of the case law appears. Such differences should be irrelevant under section 337.

Such emphasis on the moment of passage of title seems improper for the further reason that it can extend indefinitely the twelve month period permitted by the statute, in consensual sales and exchanges. In voluntary contracts of sale the parties can advance or retard the passage of title as suits their purpose. Indeed, retention of title simply as a security device is common, and thus could postpone sales for section 337 purposes for 20 or 25 years. Recognition of the unsuitability of passage of title as a test is what prompted the Government to take the position it did and this Court to hold as it did in *Commissioner v. Court Holding Co.,* supra, 324 U.S. 331. If section 337 is interpreted to sanctify this formality, no consensual sale or exchange need ever occur prior to the adoption of a plan of liquidation.

Yet section 337 was not adopted to overrule this Court's decision in *Court Holding,* but instead to provide an alternative rule not dependent on difficult questions of fact. Where a corporation does not invoke the procedures of section 337, the *Court Holding* rule still governs. The legislative history of section 337 suggests an entire absence of purpose to extract any single formality and exhalt it to controlling effect. The Treasury Regulations make the same suggestion and provide for reference to all "the terms of the contract and the surrounding circumstances." Treas. Reg. 1.337-2(a).

Consistently with the remedial nature of section 337, the Treasury Regulations are liberal in instances of consensual sales, allowing the corporation a maximum opportunity to adopt a plan of liquidation before the "sale or exchange" will be deemed to have occurred. Treas. Reg. 1.337-2(a). They provide that "the fact that negotiations for sale may have been commenced, either by the corporation or its shareholders, or both shall be disregarded. Moreover, an executory contract to sell is to be distinguished from a contract of sale." In any analogy to consensual sales, the cases involving involuntary conversions from fire or explosion are correct and those involving involuntary conversions are wrong, since there is not even so much as an executory contract of sale where the price remains to be negotiated or fixed.

No reason is apparent why a treacherous and dangerous test should be applied to treat condemnees more harshly than victims of insured fires and explosions. The same element of surprise and lack of control of the involuntary conversion is present in each, and in each events ordinarily remove the opportunity of adopting a plan of liquidation before fate or the sovereign unilaterally acts. The rule the cases apply to fires and explosions can as easily be applied to condemnations: this rule is that the sale does not occur until the gain has been realized under standard tax concepts. This is essentially the rule the regulations apply to consensual sales. Its application to condemnations would relate section 337 to its purpose, which is to permit corporations to elect to dissolve before gain has been realized from the disposition of their principal asset, and to eliminate the tax at the corporate level if they do so.

Under normal tax rules, the gain here was not realized either when title passed or the United States assumed the

corporations' indebtedness.[6] The gain would not have been realized until the award was made. *Patrick McGuirl, Inc. v. Commissioner,* 74 F.2d 729 (C.A. 2, 1935), cert. den. 295 U.S. 748 (1935); *Nitterhouse v. United States,* 207 F.2d 618 (C.A. 3, 1953), cert. den. 347 U.S. 943 (1954), reh. den. 347 U.S. 970 (1954); *Commissioner v. Henry Hess Co.,* 210 F.2d 553 (C.A. 9, 1954). Conceivably some of it would have been realized when the court released the deposit to the condemnees, but this occurred after the plans of liquidation had been adopted and therefore would not affect us adversely under the rule for which we argue.

Accordingly, this case presents important questions under section 337 of the Internal Revenue Code of 1954 which this Court should decide not only to achieve equality of treatment in all types of involuntary conversions but to prevent adoption of an unsound rule extending to consensual contracts of sale.

2. The decision below, in holding that gain in a condemnation taking accrues to a dissolving corporation prior to the making of the award in a contested matter, conflicts specifically with *Commissioner v. Henry Hess Co.,* 210 F.2d 553 (C.A. 9, 1954), and generally with *Cold Metal Process Co. v. Commissioner,* 247 F.2d 864 (C.A. 6, 1957). It also conflicts in principle with decisions of this Court, exemplified by *United States v. Safety Car Heating Co.,* 297 U.S. 88 (1936), *Dixie Pine Co. v. Commissioner,* 320 U.S. 516 (1944), *Security Mills Co. v. Commissioner,* 321 U.S. 281 (1944), and *United States v. Consolidated Edison Co.,* 366 U.S. 380 (1961). This conflict is in an area where tax controveries proliferate. It should be resolved.

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6. The corporations took no part in that act, and could not have escaped continued liability to the United States had the ultimate award been low enough. Concerning the lenders, the United States had been liable from the outset, having guaranteed the debts. This aspect of the case is more fully analyzed under the second question presented, infra p. 11.

The conflict with *Henry Hess* is direct. In both cases the United States Government took title to privately owned property under its power of condemnation, in both cases it had possession, in both cases there was a dispute about just compensation, in both cases the owning corporation was on the accrual basis, and in both cases the corporation dissolved before the dispute about compensation was resolved. In *Henry Hess* the Court of Appeals for the Ninth Circuit held that in these circumstances the gain did not accrue to the corporation and was not taxable to it. The court below held to the contrary.

*Cold Metal Process* (supra, 247 F.2d 864), although it did not involve the accrual of gain arising from a condemnation, presented essentially the same issue and was decided by the Court of Appeals for the Sixth Circuit in accordance with *Henry Hess,* on which it relied.

The principle that neither contested income nor contested deductions accrue to an accrual basis taxpayer until the contest has been determined is firmly based on the decisions of this Court cited above. One of them (the *Safety Car Heating* case, 297 U.S. 88) involves the accrual of income, and the others involve deductions. Nothing this Court has said about the principle would distinguish between them. Indeed, the *Safety Car Heating* case, which involved income, can be said to be the parent of the doctrine.

The court below here considered itself free to disregard the established rule because the United States, in transactions to which the corporations were not parties, agreed with the mortgage creditors that it would be primarily liable for the mortgage debt. The court below read too much significance into this circumstance. The United States had been guarantor of the mortgage debt from its inception. When it seized the assets and cut the corporations

off from the rental income required to service the debt,[7] it automatically triggered its own liability to the creditors under its guaranty. Viewed in the light of these circumstances, its agreements with the creditors merely served to avoid acceleration of the balance due and preserve its right to pay the debt off in installments, by forestalling foreclosure on account of the condition its own conduct had brought about.

The agreements with the creditors made their garnishment of the corporations' claims against the United States unnecessary, assuming such garnishment lawful under the Assignment of Claims Act (31 U.S.C. 203). Obviously it served the purposes of the United States to make the agreements. They did not, however, serve to eliminate the corporations' liabilities, as principal debtors, to the United States, the guarantor. The accounting between the United States and the four Wherry corporations remained to be concluded in the court proceeding invoked by the United States in condemning the properties in which the just compensation remained to be determined. Not until 1962 did that occur. By that year the corporations had been dissolved and liquidated pursuant to section 337 liquidations begun on August 11, 1958 and timely concluded on August 8, 1959. Under *Henry Hess* no income could accrue to them after August 8, 1959, and under that same decision no gain could accrue to them while the award remained contingent on litigation.

*Henry Hess* and the instant case have another circumstance in common, not heretofore mentioned. In *Henry Hess* partial compensation was paid on account in 1943, the year after the corporate dissolution, and the remainder was paid

7. Other government regulations prohibited these corporations from engaging in any other business (Fed. Housing Admin. Regs., 24 C.F.R. 803.23).

in 1944. In the instant case, partial compensation was released by the district court to the corporations in August and September of 1958, after the steps to dissolve pursuant to section 337 had been initiated. In *Henry Hess* the significance of the payment on account was not decided because it occurred after the completion of the dissolution and presented no issue different from the final payment. In the instant case it presents no issue of significance either, since it was paid after the section 337 liquidation had been started. If, as we contend above, the earliest event which could possibly constitute the "sale" under section 337 is the first receipt of partial payment by the corporations, their receipt of that payment after their liquidation had begun but before it was complete gives no difficulty.

If it needs to be considered, however, there is a further important question raised by the receipt of part payment. Even though it was released by the court, the corporations' right to retain it depended on the size of the ultimate award. The corporations or their transferees might have had to repay it.[8] The obverse of that contingency prevented accrual in *United States v. Consolidated Edison Co.*, supra, 366 U.S. 380.[9] The question is whether a contingency which would prevent accrual of a deduction would also prevent

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8. The Capehart Act (42 U.S.C. 1594(a), 70 Stat. 1111-2, as amended by P.L. 85-104, 71 Stat. 303) as it stood in 1957 and 1958 provided that the release of the deposit was "without prejudice to any party to the proceeding." It thus retained the rule of *United States v. Miller*, 317 U.S. 369 (1942), where this Court allowed the Government to recover the portion of a released deposit in excess of the ultimate award. That rule is also stated in Rule 71A(j) of the Federal Rules of Civil Procedure.

The amount of the deposit has "no bearing whatsoever on value." *Chapman v. United States*, 169 F.2d 641, 644 (C.A. 10, 1948), cert. den. 335 U.S. 860 (1948).

9. The result of that case would not obtain today under I.R.C. section 461(f), but that code section involves deductions only, not the accrual of income. Nor would it apply to events in 1958 and 1959.

accrual of income. No reason in principle appears why it should not, and this Court has not distinguished between income and deductions in this respect. However, an earlier decision (*North American Oil v. Burnet,* 286 U.S. 417 (1932)) may be to the contrary, although there the Court expressly stated that the record was silent whether the taxpayer was on the accrual basis, and its statement that the accounting method employed was irrelevant related to the issue presented by an earlier year, not the year of contingent receipt.

*Henry Hess* was not called to the attention of the court below, but the decisions from this Court cited above were. It referred to them in its opinion (App. p. 7), without, however, perceiving their significance here.

In summary, there is a conflict between the decision below and that of another court of appeals in *Commissioner v. Henry Hess Co.*, 210 F.2d 553 (C.A. 9, 1954), which can be avoided only by concluding that some of the gain accrued when the partial payments were released to the corporations after their dissolution had begun. That conclusion, while avoiding the conflict, would lead to the further conclusion that the dissolution was timely under section 337. In that event the decision below would be wrong for the additional reason discussed above, which, as we have demonstrated, is also an appropriate one for review.

3. (a) The decision below should be reviewed for the further reason that it would establish a principle of wide application not heretofore found in the appellate cases, in a manner contrary to the code and regulations. It involves the improper resolution of a conflict between two code sections.

The shareholders of Honolulu Corp. were at all times the ultimate beneficial owners of Topeka, the four Wherry

corporations, and Honolulu Corp. They were required by Federal Housing Administration Regulations (24 C.F.R. 803.23) to place only Wherry housing activities and properties in the Wherry corporations. Those corporations had losses from the Wherry housing business and could under those regulations not embark on other businesses to produce offsetting income.

During the fiscal years ended in 1954, 1955, 1956, 1957 and 1958, Honolulu Corp. owned control of the Wherry corporations and also of Topeka, and filed a consolidated return for all of them and itself.[10] The privilege to do so permitted the Wherry corporations' losses to be offset against the income of other members of the consolidated group. In 1956 it appeared that Topeka's assets should be sold. They consisted of more than 400 houses near Topeka, Kansas. Topeka sold all of them to the Wherry corporations at a profit to itself of $882,967.39. The Wherry corporations then retailed the houses to the general public for an additional profit of $387,654.00, and applied this profit against their operating loss carryforwards. These transactions appeared in the Honolulu corporation's consolidated tax return, which included Topeka.

The Commissioner allocated the entire profit, both wholesale and retail, to Topeka, acting under the supposed authority of Internal Revenue Code section 482. However, neither Topeka nor the Wherry corporations had filed separate tax returns. Instead, their gross incomes and deductions were included in Honolulu corporation's consolidated return. The Treasury Regulations pertaining to consolidated returns are true legislative regulations,[11] and the election to file pursuant to them constitutes an accept-

10. Until February 10, 1958.

11. I.R.C. sections 1501, 1502.

ance of them. Treas. Reg. 1.1502-1A(a). Moreover, in the year in question the election to do so produced a two percent additional tax.

This two percent additional tax was paid for the privilege of freely having inter-consolidation transactions, including the right to pay intercompany dividends without further tax. In the years in question, the regulations so providing also contained this provision (Treas. Reg. 1.1502-31A(b):

> "(b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:
>
> (1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:
>
> (i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions)...."

The consolidated return regulation thus eliminated all profit of Topeka on its sales to the Wherry corporations, whatever its amount, and allocated all of it to the Wherry corporations. The effect of what was done below was to reverse the effect of the regulation.

The decisions below were based on the supposed effect of section 482. Until this case it had been thought that the consolidated return regulations were the exclusive source of rules governing intercompany transactions where consolidated returns were filed. They contain many provisions in conflict with code sections of general application: viz., freedom of intercompany dividends from tax versus sections 61(a)(7) and 243(a) and carryover basis on intercompany sales versus section 1012. They contain no authoriza-

tion to apply section 482 so as to override the above regulation. The section 482 regulation relied on below (Treas. Reg. 1.482-1(b)(2)) can not be interpreted to override the consolidated return regulations.

The legislative history of section 482 shows it to be without application to consolidated returns. It first appeared in its present form as section 45 of the Revenue Act of 1928. The 1928 Act removed all provision for consolidated returns. Section 240 of the 1926 Act had permitted affiliated groups to file consolidated returns, and section 240(f) was the forerunner of section 45 (now section 482), but with significant differences. Section 240(f) permitted the Commissioner to "consolidate the accounts of . . . related trades or businesses," and required him to do so on the taxpayer's request. The new section was rewritten for the deliberate purpose of requiring allocation between taxpayers instead of consolidation of them. H. Rept. 2, 70th Cong., 1st Sess., pp. 16-17.

When the provision for consolidated returns was reintroduced by section 159 of the 1942 Act (amending section 141 of the 1939 Act to extend it to all corporations instead of merely railroad corporations), section 45 was left intact and unchanged. Clearly, then, it was thought not to provide for any type of consolidation.

(b) Moreover, section 482 was misapplied, assuming its applicability to consolidated returns, to an extent that could make it take over the roles Congress intended for sections 269 and 1551. The Tax Court found that the sale from Topeka to the four Wherry corporations was motivated by a desire to save taxes through applying some of the net operating loss carryovers of those corporations to the expected gain from the sale of Topeka's houses. It and the appellate court therefore applied a section 269 technique,

not a section 482 technique. The former would be to recreate the situation to what it would have been if no tax avoiding steps had occurred. The latter would be to allocate the income between Topeka and the four Wherry corporations, assigning the wholesale profit to Topeka and the retail profit to the four Wherry corporations. That was not done by the courts, although it was what the parties themselves had apparently attempted to do.

Section 269 could not have been applied. There are two conditions for its application, and neither was present. First, there was no shift in control. The transferor and transferees were all owned by the same common parent after the transfers as before, and section 269 is concerned with transfers accompanied by an acquisition of or shift in corporate control. Second, a new stepped-up basis in property resulted from its purchase by the four Wherry corporations, and the second concern of section 269 is transfers of property between corporations not theretofore commonly controlled where the transferor's basis carries over. These limitations on the application of section 269 will be rendered meaningless if section 482 can accomplish the same thing as section 269 does where it applies.

Congress also provided section 1551 to overcome certain types of tax avoidance by use of corporations. It, like section 269, is inapplicable here. The transferee corporations were already in business, so an essential condition of section 1551 is absent. The courts below simply avoided that limitation by allocating the income away because of the tax avoidance which would otherwise occur.

The Court of Appeals stated that this stretch of section 482 must be within the Congressional purpose because tax avoidance would otherwise result. (App. p. 12). What the court overlooked is that Congress deliberately wrote sec-

tions 381 and 382 so that the parties could have done the same thing by a merger of the four Wherry corporations into Topeka. Cf. *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (C.A. 9, 1965). Because there was no shift of beneficial interest, section 382 would not have provided for any dilution of the effect of the carryovers.

It is important that courts observe the limitations the statutes express on denying taxpayers the tax reductions Congress has seen fit to confer. So long as corporations are taxed differently than individuals, individuals will use the corporate form to lighten the tax load of their businesses. Congress is aware of this, and has not authorized a heavy handed undoing of corporate tax advantages wherever they are obtained consciously.

To apply section 482 as was done here is to undo what Congress has carefully wrought in writing the limitations found in sections 269 and 1551, and to transform section 482 into a weapon it was not designed to be.

Section 482 is a much older section than sections 269 and 1551, dating back in substantially its present form to section 45 of the Revenue Act of 1928. It does not depend for effectiveness upon a finding of a tax avoidance purpose, whereas sections 269 and 1551 do. Neither, unlike them, does it authorize allocating to one corporation all the income it took two to create. It speaks of "allocating" income "among" corporations, not all to one and none to others. This may be why Congress thought it would not do what sections 269 and 1551 do, and enacted the latter two.

This Court should review this decision to prevent the establishment of a precedent which will have the effect of undoing the limitations Congress has designedly placed in sections 269 and 1551.

## CONCLUSION

The writ of certiorari should issue.

Respectfully submitted,

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**(Appendix A Follows)**

**Appendices B, C and D appear in separate volume.**

## *Appendix A*

*In the United States Court of Appeals*
*for the Tenth Circuit*

Nos. 10060-10091

Likins-Foster Honolulu Corp., et al.,
Petitioners,

vs.

Commissioner of Internal Revenue,
Respondent.

Before PICKETT, HILL and HOLLOWAY, Circuit Judges.

PICKETT, Circuit Judge: Likins-Foster Honolulu Corporation and its shareholders petitioned for a review of adverse decisions of the Tax Court redetermining deficiencies against Honolulu and various wholly or partially owned subsidiaries and the shareholders thereof. The tax liabilities of 20 transferee shareholders are contingent upon the decision in the principal case. The Commissioner has cross-petitioned as to one of the issues in the principal case and in order to protect an alternate position, has cross-petitioned in 10 of the transferee cases.

The material facts giving rise to this controversy were stipulated by the parties or are not in dispute, and were the subject of extensive findings by the Tax Court. Four wholly-owned subsidiaries of Honolulu owned Wherry Act housing projects[1] which were condemned by the United States

1. See 12 U. S. C. § 1748 et seq. This court has previously had occasion to discuss the nature and operation of the "Wherry Act." *Sill Corporation v. United States*, 10 Cir., 343 F. 2d 411, *cert. denied*, 382 U. S. 840; *Buena Vista Homes, Inc., v. United States*, 10 Cir., 281 F. 2d 476.

pursuant to the provisions of the Capehart Act, 42 U. S. C. § 1594a, on October 30 and November 1, 1957. The projects were located at Biggs Air Force Base, Texas and Ft. Ord, California. The complaints and declarations of taking filed under 40 U. S. C. § 258a recited that the estate being taken consisted of all right, title and interest of the particular Wherry corporation "subject to the interest of" the mortgagees. The Wherries contested the proceedings only with regard to the issue of just compensation. In 1960 and 1962 judgments were entered on jury verdicts which were substantially in excess of the sum of money estimated to be just compensation for the property taken and deposited in court with the declaration of taking.

It was stipulated that subsequent to the dates of the filing of the condemnation complaints and the declarations of takings the Wherries made no further payments to the mortgagees on the notes secured by the condemned properties. Subsequent to the condemnation proceedings the United States entered into agreements with the mortgagees assuming the liabilities of the Wherries on the mortgages. These agreements recited that they were executed "as of December 27, 1957," as to Biggs and El Paso and "as of November 1, 1957" with respect to Ord and Monterey. The Wherry Corporations were not parties to these agreements and refused to sign supplemental agreements submitted by one of the mortgagees evidencing release of their liability as mortgagors.[2] For the fiscal years ending June 30, 1954 through June 30, 1957 Honolulu and its subsidiaries filed consolidated income tax returns. After February 10, 1958 Honolulu ceased

2. Counsel for the Wherries was of the opinion that his clients were protected by the agreements and that there was no need to execute separate documents of release. When the supplemental agreements were submitted counsel declined to execute them again because he believed his clients were protected and also because he believed signing the release might compromise his clients' position in the condemnation suits.

to hold 80% of the stock of Ord, Monterey, Biggs and El Paso and was no longer eligible to file consolidated returns with these subsidiaries. Each of these corporations filed separate returns for the period February 11, 1958 to June 30, 1958 and for the fiscal year ending June 30, 1959.

Following disclaimer by the mortgagees the Wherries withdrew the deposits pursuant to court order in August and September, 1958. In the fiscal years 1958 or 1959 neither the consolidation nor the subsidiaries in their separate returns reported any income resulting from the condemnations. The Commissioner determined that Honolulu and its subsidiaries had realized gain in the fiscal year ending June 30, 1958 in the amount of the excess of the mortgage principal outstanding as of the dates of condemnation over the depreciated cost basis of the Wherries in the properties condemned. The Tax Court sustained this determination and the taxpayers concede their liability, but dispute the date upon which their gain was realized. It is the position of the taxpayers that the United States took the properties as a whole and became liable for just compensation for the entire value of the respective projects without regard to the amount due on the mortgages, and that at the time of taking the United States was not liable for the payment of the mortgages. Consequently, it is said that because the taxpayers were entitled to be paid for the whole property the liability of the United States on the mortgages was not determined at the date of taking and the continued liability of the mortgagors affected their right to compensation. They support this position by a broad attack on the power of the United States to condemn the projects subject to the outstanding mortgages. This issue was not raised in the condemnation proceedings. The sole issue tried there was the amount of the compensation to be paid for the taking of the property. *Likins-Foster Monterey Corporation v. United States,* 9 Cir., 308 F.2d 595. While this may be a collateral

attack upon the condemnation judgment,[3] we are satisfied that by the enactment of the Capehart Act and supplemental legislation, 70 Stat. 682, Congress intended to authorize the United States to condemn Wherry Act projects and to take title to the owners interest therein subject to existing mortgages. *United States v. Certain Interests in Property, Etc.*, 7 Cir., 271 F.2d 379, *cert. denied*, 362 U. S. 974. The legislative history of the Act contains a summary of the procedure to be followed in determining the sponsor's interest and concludes: "To determine the value of the lessee's interest it would be necessary for the Commissioner to ascertain the difference between the purchase price as determined by him and the principal obligation (the Mortgage), plus accrued interest." In the following paragraph it is stated: "The Secretary of Defense would assume or purchase subject to the balance due under the insured note secured by the Mortgage on such housing and make all future payments thereon. 3 U. S. Code Cong. and Admin. News 1956, page 4552, 84th Cong., 2nd Session. See also the 1956 Amendments, 70 Stat. 1091 at 1112, indicating in the context of other types of condemnations that the measure of compensation is the difference between the outstanding principal obligation plus interest and the price of the property fixed by the court, and thus confirming that it is the equity in Wherry Act housing which is condemned.

We believe a reasonable interpretation of the Act to be that condemnation of the equities was authorized by the statutes, as was done in these cases. The takings were effected under the statutes on the filing of the declarations of taking and making of the deposits. 40 U. S. C. § 258a. As it was obligated to do in such circumstances, the Government thereafter made the mortgage payments. It also made

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3. The Commissioner has not questioned the jurisdiction of the Tax Court to consider this question. See *Commissioner v. Gooch Co.*, 320 U. S. 418; *Taylor v. Commissioner of Internal Revenue*, 2 Cir., 258 F. 2d 89.

the assumption agreements with the mortgagees, as mentioned above. By such assumption of the mortgages with the assent of the mortgagees the Government became directly and primarily liable to the mortgagees. *Fitzgerald v. Flanagan,* 155 Iowa 217, 135 N. W. 738; *Union Stove & Machine Works v. Caswell,* 48 Kan. 689, 29 P. 1072. Moreover, such procedure in no way prejudiced the rights of the mortgagors to just compensation for their interests and presented no Constitutional questions. We conclude that such takings of the equities were authorized by the statutes and not violative of the Fifth Amendment.

The law is settled that where mortgaged property is sold and the mortgagor's indebtedness is canceled by the assumption of the mortgage by a third party, the amount of gain realized by the seller is measured by the excess of the outstanding mortgage principal over the seller's basis in the mortgaged property. Int. Rev. Code of 1954, §§ 61(a)(12) and 1001; *Crane v. Commissioner,* 331 U. S. 1; *Commissioner v. Jacobson,* 336 U. S. 28. It is also accepted law that for capital gains purposes, involuntary conversions such as condemnations are treated as "sales or exchanges" under the statute. *Kieselbach v. Commissioner,* 317 U. S. 399; *Hawaiian Gas Products v. Commissioner of Int. Rev.,* 9 Cir., 126 F.2d 4, *cert. denied,* 317 U. S. 653. See 3B Mertens, Federal Income Taxation, § 22.100.

In the condemnation proceedings, as provided by 40 U. S. C. § 258a, title to the Wherry projects vested in the United States upon the filing of the declarations of taking and the payment into court of the estimated compensation. *Covered Wagon, Inc. v. C. I. R.,* 8 Cir., 369 F.2d 629; *Travis v. United States,* Ct. Cl., 287 F.2d 916, *cert. denied,* 368 U. S. 824. The nominal character of the initial deposits in the Texas condemnations did not delay the vesting of title in the United States. *United States v. Cobb,* 9 Cir., 328 F.2d 115. The date title vested in the United States is also the date the "sale or exchange" necessary for capital gains

treatment occurred. *Kieselbach v. Commissioner, supra; Covered Wagon, Inc. v. C. I. R., supra.* See 3B Mertens, *supra,* § 22.103.

Except as to Ord, which is discussed in the appendix hereto, we conclude that gains to the mortgagors in connection with the cancellation of their mortgage indebtedness occurred on the execution of the agreements by the Government to assume the mortgage obligations, together with the release of the mortgagors by the mortgagees. See *Riss v. C. I. R.,* 10 Cir., 368 F.2d 965, 968; *Newmark v. C. I. R.,* 2 Cir., 311 F.2d 913; *Clarke v. United States,* 94 F. Supp. 543, 548 (E. D. Pa.); and 2 Mertens, Federal Income Taxation, § 11.19. Although the right of the mortgagors to have the Government take over the mortgage obligations existed from the condemnation of the equities, there was no assumption of their mortgage obligations until the agreements were made and resulting gains to the mortgagors did not occur until there was an assmuption and a release of their obligations on the mortgages. See *Riss v. C. I. R., supra; cf. Nitterhouse v. United States,* 3 Cir., 207 F.2d 618, *cert. denied,* 347 U. S. 943. To this extent we disagree with the views of the Tax Court. We treat the details as to the effect of the agreements with respect to the four Wherry corporations in the appendix hereto and there discuss our determinations of the effective dates of the release of the mortgagors on the mortgages, taking into consideration the differences in the agreements. As to Ord, for reasons stated in the appendix, we conclude that the Tax Court on remand should consider the agreement and the surrounding facts and determine when there was an effective release and resultant gain. See *Cardwell Investment Co. v. United Supply and Manufacturing Co.,* 10 Cir., 268 F.2d 857, at 860.

The Wherry Corporations commenced liquidation on August 11, 1958 and terminated their existence on August 8, 1959. The taxpayers contend they were entitled to nonrecog-

nition of gain treatment provided by 26 U. S. C. § 337(a) with respect to gain realized on the withdrawal of deposits following the commencement of the liquidation. The Tax Court held that § 337 was not applicable because the properties had not been sold within 12 months following the adoption of their plans of liquidation. The taxpayers challenge this holding asserting that the "sale" required by § 337 was consummated after the adoption of the plan of liquidation when the amount of compensation was determined. Section 337 has no application here because the sale or exchange of the property occurred on the date of the taking by the United States in the condemnation proceedings. The courts have uniformly held that the necessary sale does not occur within 12 months of the adoption of a plan of liquidation where title to the condemned land had vested prior to adoption of the plan. *Covered Wagon, Inc. v. C. I. R., supra; Dwight v. United States,* 2 Cir. 328 F.2d 973; *Wendell v. C. I. R.,* 2 Cir., 326 F.2d 600, and cases cited therein; *Rev. R.* 59-108, 1 *Cum. Bul. 72; cf. West Street-Erie Boulevard Corp. v. United States,* N. D. N, Y.. 294 F. Supp. 145, aff'd in part (2 Cir.), — F.2d —; *Feinberg v. C. I. R.,* 8 Cir., 377 F.2d 21.[4]

Honolulu as parent of the consolidated group will become liable for the gain realized by the Wherry Corporations as a result of the condemnations in fiscal 1958. Int. Rev. Code of 1954, § 1552(a)(1) and (b); Treas. Regs. § 1.1502-30A.

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4. The taxpayers' reliance on *United States v. Morton,* 8 Cir., 387 F. 2d 441, is obviously misplaced. The Eighth Circuit held that where a plan of liquidation was adopted after a fire loss but before settlement of an insurance claim, the date of sale was the date of claim settlement rather than the date of the fire. The Court expressly adhered to its earlier decision in *Covered Wagon* with respect to an involuntary conversion by condemnation. In addition, the rationale of *Morton* turned on the fact that the amount to be received by way of reimbursement was unascertained prior to adoption of the plan of liquidation, whereas the amount of the deposits sought to be taxed in this case as capital gain was determined either on the date of condemnation or prior to the adoption of the plans of liquidation.

When the Wherries withdrew the escrow deposits in early fiscal 1959, the funds were credited on the books of Honolulu as "Gain on Sale of Assets" and thereafter were alternatively treated as either "liquidated dividends" or as a collection on the "chose-in-action" which the Honolulu Corporation was to receive as a result of liquidation. Honolulu now seeks to offset against the 1959 liquidating dividends its 1958 liability for the taxes owed by the Wherries by treating the Wherries liability as a retroactive account receivable, thereby substantially reducing its tax liability for the fiscal year ending 1959. The total tax liability of the consolidated group growing out of the condemnation of the Wherry projects was $605,794. The taxpayers assert that Honolulu, which must now pay the tax, may treat it as a retroactive account receivable and offset proportionately the amount of the liquidating dividend paid by each of the Wherries in August and September, 1958. The Tax Court held the liability of the Wherries for taxes would not accrue until the termination of this litigation in which liability is denied and cannot be reflected on Honolulu's 1959 tax return. In disposing of this issue we agree with the following statement of the Tax Court:

> "Petitioners argue that since Honolulu is not only liable as a transferee of its former subsidiaries but also because for some years prior to the fiscal year 1959 it filed consolidated returns with these affiliates, the holdings in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), and *James Armour, Inc.*, 43 T. C. 295 (1964), are inapplicable. Any deficiencies in tax which may be determined when the decision of this Court is entered with respect to Monterey and other 'Wherry' corporations which Honolulu is required to pay are not a liability which is finally determined until the decision of this Court is entered. It was because such liability was not fixed or paid until a later year, and not merely because the liability was a transferee liability, that formed the

basis of the holding in *Arrowsmith v. Commissioner, supra,* and in *James Armour, Inc., supra,* that the deduction should be taken in the later year. Therefore under the holdings of these cases, Honolulu is not entitled to deduct any amounts of the liabilities of the 'Wherry' corporations which it may ultimately be called upon to pay until they are either finally determined or paid. In effect, Honolulu is attempting to obtain a deduction for the yet undetermined taxes of the 'Wherry' corporations which it may eventually be called upon to pay by reducing its gain from liquidating distributions from such corporations in the fiscal year 1959 by the yet undetermined amounts."

See also *U. S. v. Consolidated Edison Co.,* 366 U. S. 380; *Security Mills Co. v. Comm'r.,* 321 U. S. 281; *Dixie Pine Co. v. Commissioner,* 320 U. S. 516. The remedial provisions of 26 U.S.C. §§ 1311-1315 have no application.

Likins-Foster Topeka Corporation, a non-Wherry subsidiary, owned in excess of 400 houses in Topeka, Kansas which it rented to the personnel of Forbes Air Force Base. Topeka conveyed the separate units in this project to the four Wherry Corporations about July 1, 1956 and in turn each Wherry sold the parcels which had been deeded to it prior to the end of fiscal 1957. At the time of the transfer each of the Wherries had substantial operating carry-over losses. They took the property subject to existing F. H. A. mortgages but did not assume them. The consideration received by Topeka upon conveyance to the Wherries was substantially less than it would have received through sales to third parties. The Tax Court concluded that tax evasion purposes could be inferred from these transactions because the value of the property transferred to each Wherry was approximately equal to the amount of carryover available to each. Following sale of the houses by the Wherries and receipt of the downpayment and additional payments, the

Wherries, having realized a gain which caused them to have income, distributed the installment contracts of the purchasers to the parent corporation as dividends. The significance for tax purposes of this series of transactions is that the Wherries then had income for fiscal 1957 against which net operating loss carryovers could be offset. The Wherries' carryovers emanated from years for which each had filed separate returns, and would have expired if not utilized in the fiscal year ending June 30, 1957. Topeka, on the other hand, had no loss carryovers available to it, and because the Wherries' carry-overs were for years in which separate returns had been filed, the carry-overs were available only to the Wherries and were not otherwise available to the consolidation or other members thereof.[5] Pursuant to 26 U.S.C. § 482, the Commissioner reallocated the total gain from the sales ($472,841) as reported by the Wherries back to Topeka. The purpose of § 482 is to permit the Commissioner to distribute, apportion or allocate gross income, deductions, credits or allowance between organizations or businesses controlled by the same interests to prevent evasion of taxes or to clearly reflect the income of such organizations. *W. Braun Co. v. C. I. R.*, 2 Cir., 396 F.2d 264; *Eli Lilly and Company v. United States*, Ct. Cl., 372 F.2d 990; *Charles Town, Incorporated v. C. I. R.*, 4 Cir., 372 F.2d 415, *cert. denied*, 389 U. S. 841; *Spicer Theatres, Inc. v. C. I. R.*, 6 Cir., 346 F.2d 704. The Commissioner contends that the Wherries were used only as conduits for the disposition of Topeka's assets in order that the consolidation might receive the benefits of the Wherries' loss carry-overs.

The Tax Court found a tax avoidance purpose and concluded that the Commissioner had the power under § 482 to

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5. Under the consolidated regulations, net operating loss carryovers from separate return years are available to a consolidation only as offsets against the income of the affiliate which actually experienced the preconsolidation loss. Treas. Regs., § 1.1502-31A(b)(3); see *Phinney v. Houston Oil Field Material Company* 5 Cir., 252 F. 2d 357.

reallocate the income to Topeka. Taxpayers do not deny a tax avoidance motive, but argue that it is irrelevant since § 482 does not apply to intercompany transactions between consolidated groups which are governed solely by § 1501 et seq. It is argued that the income to be reflected in a consolidated return is the income computed under the consolidation sections; that since the Commissioner has ruled that transfers between components of a consolidation are not transfers resulting in gain or loss, there is no income to be allocated under § 482. The Government counters urging that since the regulations, § 1.482.1(b)(2), providing that § 482 applies in the case of any controlled taxpayer, "whether such taxpayer makes a separate or a consolidated return", have been continued without change through several reenactments of the I. R. C., the regulations are deemed to have been given Congressional approval.[6]

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6. Section 1.482-1(b) is as follows:

"(1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

"(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidatel taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return."

Aside from the various legal niceties, it seems apparent that the taxpayer should not be allowed to prevail on the basis of form over substance. It is true that 26 U. S. C. 1501 et seq. governs consolidated returns. However, § 1502 expressly delegates power to promulgate regulations to assure a proper reflection of income. One of those regulations—which is not challenged by the taxpayer—provides that preconsolidation loss carry-overs can be offset only against the specific affiliate that incurred the loss. Whether this is accomplished by a direct transfer of loss carry-overs from the loss corporation to the consolidation to offset the group's income (specifically prohibited and recognized as prohibited by the taxpayers) or whether this is accomplished by transferring group income to the loss corporation (the method employed here) should make little difference. In either case, the result works the same tax distortion and cannot be sustained.

The final issue raised here arises out of a cross-appeal by the Commissioner from an adverse decision of the Tax Court concerning distributions during the fiscal year 1956 to Honolulu by two of its subsidiaries which distributions were in excess of Honolulu's basis in the stock of the distributing corporations.[7] At the time of the distributions, the subsidiaries making the distributions had no earnings or profits. Consequently, payments were not dividends as defined by 26 U. S. C. 316(a). Non-dividend distributions "shall be applied against and reduce the adjusted basis of the stock." 26 U. S. C. 301(c)(2). The difficulty arises here because the parent had already received the amount of its basis in the stock. The Tax Court concluded that although the distributions were not dividends, they were "intercompany transactions" under Treasury Regulations 1.1502-31A

7. It is without dispute that the distributions were with respect to stock as provided by § 301(a), I. R. C. 1954, and that § 301(c) applies in the absence of a controlling provision of the consolidated regulations.

(b)(2)(iii)(a) and eliminated from income of the parent corporation which received it for the purpose of making a consolidated return. The Commissioner's contention is that the distributions in excess of Honolulu's basis in the stock of the subsidiaries are taxable under § 301(c)(3)[8] and that the consolidated return regulations do not provide for their elimination from income. It is argued that because of the permanent tax avoidance resulting from the Tax Court's decision the regulations relating to treatment of capital gain in intercompany transactions should not be applied. Specifically, the Commissioner contends that no carry-over basis existed which would reflect gain upon the sale of the property to an outsider.[9] The Tax Court was of the opinion that there was only a possibility that the distributions had or would escape taxation. In this connection the Court said:

> "Expressed another way, to the extent that the cash which was distributed to the parent was accumulated by the subsidiaries during consolidated years, it very likely has in some way been taxed as an overall part of the consolidation. The fact that respondent in connection with redemption of stock issued a specific regulation which we will subsequently discuss, does not justify reaching a conclusion specifically contrary to another portion of his regulations where he has not chosen to change those regulations."

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8. 26 U. S. C. 301(c)(3) is as follows:
"Amount in excess of basis.—(A) In general.—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property."

9. It appears that the Commissioner's new regulation treating this subject, § 1.1502-14(a)(2), would postpone recognition of the income resulting from non-dividend distribution by recording it in an "excess loss account" which is applied to the parent's income when the stock in the subsidiary is sold, or when the affiliation of the subsidiary with the consolidated group is terminated. §1.1502-19(a) and (b).

Relying on *American Water Works Co. v. Commissioner of Int. Rev.*, 2 Cir., 243 F.2d 550, the Court also concluded that the reduction in basis of the stock of the subsidiaries in the hands of the parent prevented tax avoidance. It is recognized that the Commissioner's treatment would be correct in the normal non-consolidation situation. However, the consolidation sections provide for non-recognition of gain on intercompany transactions:

> "There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another. . . ." (§ 1.1502-31A(b)(1)(i))

Thus, the Tax Court holding that the regulations expressly eliminated capital gain transactions between affiliates must be upheld.

The decision of the Tax Court in these consolidated cases is modified as stated herein and the cases are remanded for further proceedings and recomputation of the tax liabilities involved in accordance with this opinion and the appendix thereto.

*Appendix*

The four Wherry corporations involved were Monterey, Biggs, El Paso and Ord. Separate three-party agreements were executed pertaining to the obligations of each on its note and mortgage. They were executed by the military department involved, the Federal Housing Administration and the bank or insurance company holding the mortgage. These agreements will be considered separately.

*Monterey:* The agreement recites that it was entered into as of November 1, 1957. However, it was acknowledged by the Assistant Commissioner for Operations of the Federal Housing Administration on July 8, 1958. The agreement contemplated executed by three interested parties. We

conclude that the assumption and release agreement was effective for the purposes of this case on July 8, 1958, the completion of its execution. See *Kent Homes, Inc. v. United States,* 279 F. Supp. 650, 655 (D. Kan. 1967).

The agreement provided that the Government assumed the obligations of the note and mortgage. It also stated that the parties agreed that the mortgagor was released from all further liability and obligation on the note and mortgage. For tax purposes we conclude that the gain of Monterey in connection with the discharge of the mortgage indebtedness occurred on July 8, 1958.

*Biggs and El Paso:* Except for an immaterial difference in dates that may exist in the last acknowledgment, the two separate agreements relating to Biggs and El Paso read alike. The acknowledgment by the Assistant Commissioner for Operations of the Federal Housing Administration was made in January, 1958, for both agreements, the exact date being illegible. We conclude that the agreements relating to Biggs and El Paso were effective for tax purposes in January, 1958, the completion of their execution.

The agreements both contained the following provision, with a difference in amount of the omitted indebtedness being stated in each:

> "... *ARTICLE I*
> ASSUMPTION AND RELEASE AGREEMENT
>
> It is agreed by the parties hereto that the Department assumes the obligation of and will make the payments called for under the terms and provisions of the mortgage and note hereinbefore referred to and the Mortgagee agrees to accept the obligation of the Department to make such payments and the mortgagee and the Department hereby agree that the unpaid principal balance of said mortgage note on the day immediately preceding the effective date of this agreement is $..... The Department and the Commissioner

agree that, without affecting liability of the Department under the foregoing assumption, the Mortgagee may release Likins Foster . . . Corporation, the original mortgagor, from all liability in connection with the said note and the mortgage and chattel mortgage securing the payment of said note . . ."

We note that the mortgagee agrees to accept the obligation of the Government and the indication of intent to release the mortgagors in the caption of the article as well. While there is not the clear release as there was to Monterey, we believe a release of the mortgagors was intended. On the basis of Article I and the entire agreements we conclude that they effected an assumption of the mortgage indebtedness of Biggs and El Paso by the Government and a release by the mortgagee of their personal liability on the notes. We conclude that the gains of Biggs and El Paso in connection with the discharge of their mortgage indebtedness occurred in January, 1958.

Ord: In the case of Ord the significant provision of the three-party agreement reads as follows:

"*. . . ARTICLE II*

ASSUMPTION AND RELEASE

That the Department does hereby assume the obligation of, and will make the payments prescribed by and in accordance with terms and provisions of, said deed of trust and the note secured thereby relating to principal, interest, and mortgage insurance premiums (beginning with the payment due November 1, 1957); that the Mortgagee and the Commissioner do hereby accept the obligation of the Department to make such payments. This undertaking by the Department shall be without prejudice to the Government's position in said condemnation proceeding with respect to the pro-rating of such payment obligation with the mortgagor for any

period during which any payment or part thereof is allocable to any period prior to the date of the filing of the Declaration of Taking . . ."*

In view of the deleted language concerning the release of the mortgagor, Ord, we doubt that we should now hold as a matter of law that the agreement alone released Ord. We feel instead that we should leave this determination to be made first by the Tax Court on remand. There, the agreement and all the facts may be considered and the determination made from the record as to when an effective release of Ord by the mortgagee occurred, and thus, when a gain by discharge of the mortgage indebtedness may have resulted. See *Cardwell Investment Co. v. United Supply and Manufacturing Co.*, 10 Cir., 268 F.2d 857, at 860. In this connection we note that when the liquidation resolution of the corporation was adopted on August 11, 1958, the minutes recognized that the corporation had been relieved of its mortgage indebtedness by the three-party agreement. At least by this date the record shows that there was a course of conduct and mutual understanding between the parties to justfy an inference that the obligation of the mortgagors had been extinguished. The mortgagee had agreed to the assumption of the mortgage by the United States, accepted the mortgage payments from it, and did not object to the liquidation of Ord.

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*The deleted language reads as follows:

". . . and that the Department, the Commissioner, and the Mortgagee do hereby agree that the aforesaid mortgagor is released from all further liability and obligation under said mortgage and the note secured thereby . . ."